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TAGS: ECON EFIN VE
SUBJECT: AN OFFER THEY CAN'T REFUSE? GBRV ASKS LOCAL BANKS
TO FINANCE DEFICIT

REF: A. CARACAS 368
¶B. 2008 CARACAS 566
¶C. CARACAS 247 AND PREVIOUS

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b)
and (d).

¶1. (C) Summary: The Government of the Bolivarian Republic of Venezuela (GBRV) has signaled its plans to ask local banks to finance a significant part of its anticipated deficit in ¶2009. The Central Bank (BCV) has taken steps to increase banks' liquidity and incentives to buy GBRV debt, reducing the reserve requirement and lowering the interest rate for its absorption operations. At the same time, banks are increasingly reluctant to lend to private sector clients and individuals. For these reasons, most bankers and financial sector experts post has consulted believe the banks will do as asked, without having to be forced. While good for the GBRV in the short term, banks' apparent willingness to buy GBRV debt is more a symptom of a deteriorating and increasingly state-oriented economy than a vote of confidence in the government's economic plans. Banks' relevance to Venezuela's economy is gradually declining, and they are increasingly becoming intermediaries between clients' transactional deposits and the GBRV. End summary.

Knock and Help Open the Door

¶2. (U) The "anticrisis" economic measures announced by President Chavez March 21 mostly concerned how the GBRV planned to close a large anticipated budget deficit for 2009 (ref A). Prominent among these measures was the intention to increase the ceiling for new debt issuance in 2009 from 12 to 34 billion bolivars (Bs), or from USD 5.6 to 15.8 billion at the official exchange rate. (Note: The National Assembly subsequently authorized a new ceiling of Bs 37 billion. End note.) As the yield demanded by international financial markets would be prohibitively high, the vast majority of debt issuances this year will be placed in the domestic market. In particular, they will be aimed at local banks, who hold more than half of GBRV domestic debt. (Note: As of December 31, 2008, the GBRV had outstanding internal debt of Bs 30.5 billion, of which Bs 17 billion was held by banks. End note.) In his remarks, Chavez claimed the banks had "plenty of room" to buy GBRV bonds and called on bankers to work with GBRV officials. On April 4, Minister of Finance Ali Rodriguez met with representatives of leading banks to discuss a schedule for placing internal debt "of more than Bs

33 billion" in 2009.

¶3. (U) As GBRV was developing its financing plans, the Central Bank (BCV) took several apparently coordinated steps to free up liquidity. It reduced the marginal reserve requirement from 30 to 27 percent on January 5 and from 27 to 25 percent on March 9, steps which post calculates will free up Bs 5.5 billion in reserves. (Note: The marginal reserve requirement applies to the difference between current deposits and deposits as of July 2006 in banks with over Bs 90 million in deposits. End note.) The BCV also reduced the interest rate for absorption operations in three phases by a total of seven percentage points (e.g., from 14 to seven percent for a BCV certificate of deposit (CD) maturing in 56 days). This reduction increases the relative attractiveness of government bonds, as the average yield for new issuances in 2009 was 16 percent through late March according to one local bank's calculations. As of February, banks owned about Bs 26 billion of BCV CDs. In other words, by continuing to reduce the reserve requirement and lowering its outstanding stock of CDs, the BCV can free up sufficient liquidity for banks to finance the deficit anticipated by the GBRV.

Banks Left With Few Options

¶4. (SBU) Most of the bankers and financial sector experts Econoffs have recently consulted believe banks will be willing to buy GBRV bonds, not because they are attractive investments but because there are few worthwhile alternatives. As the economy falters and directed lending becomes more onerous (ref B), banks have cut back credit to

private clients. For the first time since at least 2004, in 2008 banks' total loan portfolio contracted in real terms, and it declined even in nominal terms in the first two months of 2009 (partly due to seasonal factors). Thanks to tighter regulations and rising delinquency, banks' profit margins are also falling, making the tax-free income from GBRV bonds increasingly attractive. The GBRV is further sweetening incentives by developing a "bono agriculo." Banks that buy this bond can count the purchase (up to a limit) toward the 21 percent of their overall loan portfolio they are required to direct to the agricultural sector. One downside of purchasing GBRV debt from banks' perspective is that it is not particularly liquid: according to one well-respected local consultant, the only real secondary market is the BCV's discount window.

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Comment: Whither Venezuela's Financial Sector?
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¶5. (C) Viewed more broadly, Venezuelan banks' likely willingness to purchase large amounts of GBRV debt is symptomatic of the financial sector's declining relevance to a faltering economy. After the GBRV implemented currency controls in 2003, the sector enjoyed a temporary boom as the economy recovered from the 2002-2003 recession and massive government spending drove liquidity up faster than inflation. As a result, from 2004 through 2007 growth in deposits in the financial sector far outstripped inflation (360 percent vs. 95 percent over the four years), and deposits as a percentage of GDP also grew. These trends were reversed in 2008 as the GBRV economic model ran out of steam, a process compounded by the steep decline in oil prices in the latter half of the year. Inflation grew faster than deposits by almost five percentage points, and deposits as a percent of GDP fell from 35 percent in 2007 to 32.3 percent by year-end
¶2008. We expect these new trends to continue in 2009.

¶6. (C) The declining weight of the financial sector in the economy does not mean it is on the verge of a crisis. With the exception of some small and medium-sized banks, the

sector continues to be relatively healthy from a solvency and liquidity perspective. Instead, the sector is simply becoming less relevant to the economy, partly because private enterprise is becoming less relevant. With real interest rates strongly negative, deposits in the financial system are largely transactional. Private investment is minimal - one banker told us many business clients are taking out loans to buy dollars on the parallel market (i.e., speculating against the bolivar) rather than invest in expanding local production. As a result, the public sector will absorb (or direct) a greater percentage of banks' assets, even as these assets decline in value in real terms. Banks are gradually converting into intermediaries between clients' transactional deposits and the GBRV.

¶7. (C) Inflation promises to reduce further the real size of the financial sector. The steps taken to date by the BCV to free up liquidity are inflationary, and more such steps are expected. Some local analysts believe that, if oil prices are stagnant into 2010, the GBRV might resort to having the BCV essentially finance the GBRV by buying GBRV debt from banks on the secondary market. The more inflationary the environment, the more negative real interest rates will become (unless the BCV raises the ceiling/floor on nominal interest rates) and the less incentive there will be to deposit money in the financial sector. Well managed banks will still be profitable, but their return on equity and asset level will decline in real terms.

¶8. (C) Given this economic context, the GBRV's penchant for nationalizing companies (or announcing their nationalization, in the case of Banco de Venezuela) without paying, and President Chavez's overall drive to socialism, bankers will not invest more discretionary capital in their banks. (Note: Bankers are obliged to reinvest a percentage of their profits. Moreover, several wealthy individuals with ties to the GBRV are seeking a foothold in the banking industry, as is the case with a supplier to the government food chain Mercal who is seeking to buy and merge three small banks. End note.) Local bankers will keep taking out as much as they can in dividends, understanding they will lose much of the capital remaining in their banks to inflation and/or

potential nationalization. International banks will also see their capital erode in value, and one of the two Spanish banks, Grupo Santander, seems to have re-entered negotiations to sell its Banco de Venezuela to the GBRV (ref C). End comment.
CAULFIELD